Supreme Court, U. S.
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IN THE
SUPREME COURT OF THE UNITED STATES

October Term, 1977

No. 77-1824

M. SETH HORNE and MAURINE D. HORNE,

Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE

Appellee.

PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

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INDEX

	Page
Opinion Below	1
Jurisdiction	2
Questions Presented	2
Statutes and Regulations Involved	3
Statement of the Case	6
Reasons for Granting the Writ	11
Conclusion	20
Certificate of Service	
Appendix, one volume (separately bound)	

TABLE OF CASES AND AUTHORITIES

Cases:	
Allen v. Commissioner, 283 F.2d 785 (7th Cir. 1960)	16
Commissioner v. Cornat Holding Co., 324 U.S. 331 (1945)	14
Eckert v. Burnet, 283 U.S. 140 (1931)	19
Howell v. Commissioner, 69 F.2d 447 (8th Cir., 1934)	11-14
Lutz v. Commissioner, 282 F.2d 614 (5th Cir., 1960)	12, 16, 20
Putnam v. Commissioner, 352 U.S. 82 (1956)	14, 15, 17
Stahl v. United States, 441 F.2d 999 (D.C. Cir., 1970)	12, 14-16, 20

	Page
Stratmore v. United States, 420 F.2d 461 (3d Cir., 1970)	14
United States v. Generes, 405 U.S. 93 (1972)	13, 16, 20
United States v. Hoffman, 423 F.2d 1217 (9th Cir., 1970)	13, 14, 16, 17, 20
Statutes:	
Internal Revenue Code of 1954	
Sec. 162 (26 U.S.C.A. § 162)	2-3, 12, 16
Sec. 165 (26 U.S.C.A. § 162)	2-3, 5, 12, 16, 19
Sec. 166 (26 U.S.C.A. § 162)	3, 10-11, 13-14, 15, 18
Sec. 1211 (26 U.S.C.A. § 162)	10-11
Sec. 6213 (26 U.S.C.A. § 162)	10
Sec. 7442 (26 U.S.C.A. § 162)	10
Sec. 7483 (26 U.S.C.A. § 162)	11
United States Code	
28 U.S.C. § 1254(1)	2
28 U.S.C. § 2483	11

Treasury Regulations

	Page
Reg. § 1.166-1(c)	6, 15
Reg. § 1.166-5	4, 18-19

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The petitioners, M. SETH HORNE and MAURINE D. HORNE, respectively pray that a Writ of Certiorari be issued to review the judgment herein of the United States Court of Appeals for the Ninth Circuit (hereinafter referred to as the Ninth Circuit) entered in the above-entitled case on September 30, 1975, petition for rehearing denied on March 27, 1978.

OPINIONS, JUDGMENTS, AND ORDERS BELOW

On November 27, 1972, the United

States Tax Court (hereinafter referred to as the Tax Court) filed its opinion herein which is reported at 59 T.C. 319 (1972) and pursuant thereto entered its decision on February 12, 1973. The opinion and decision are set forth in the appendix at pages 1 through 40 and at page 41, respectively.

The Ninth Circuit filed its opinion and judgment on September 30, 1975, affirming the decision of the Tax Court. The opinion is reported at 523 F.2d 1363 (9th Cir., 1975) and set forth in the appendix at pages 42 through 49.

On March 27, 1978, the Ninth Circuit filed its order denying petitioners' petition for rehearing. The order is set forth in the appendix at page 50.

JURISDICTION

The judgment of the Ninth Circuit was filed on September 30, 1975, and the order denying the petition for rehearing was filed on March 27, 1978. Jurisdiction of this Court is invoked under 28 U.S.C. Section 1254 (1).

QUESTION PRESENTED

Where the taxpayer, M. SETH HORNE, made payments pursuant to an indemnity agreement, entered into by him with a bonding company concerning an antecedent debt for which he had no responsibility, are such payments deductible either as ordinary and necessary business expenses under Section 162 or losses incurred in a trade or business, or incurred in a transaction entered into for profit under Section 165(c) of the

Internal Revenue Code of 1954?

STATUTES AND REGULATIONS INVOLVED

Internal Revenue Code of 1954:

SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) In General.--There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business,
. . .

(26 U.S.C.A. § 162)

SEC. 165. LOSSES.

(a) General Rule.--There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

(c) Limitation on losses of individuals.--In the case of an individual, the deduction under subsection (a) shall be limited to

(1) losses incurred in a trade or business;
(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business;

(26 U.S.C.A. § 165)

SEC. 166. BAD DEBTS.

(a) General Rule.--

(1) Wholly worthless debts.--There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

.....

(d) Nonbusiness Debts.--

(1) General rule.--In the case of a taxpayer other than a corporation--

(A) subsections (a) and (c) shall not apply to any nonbusiness debt; and . . . .

(2) Nonbusiness debt defined.--For purposes of paragraph (1), the term "nonbusiness debt" means a debt other than--

(A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

(26 U.S.C.A. § 166)

Treasury Regulations:

REG. § 1.166-5

* * *

(b) Nonbusiness debt defined--For purposes of section 166 and this section, a nonbusiness debt is any debt other than--

(1) A debt which is created, or acquired, in the course of a trade or business of the taxpayer, determined without regard to the relationship of the debt to a trade or business of the taxpayer at the time when the debt becomes worthless; or

(2) A debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

The question whether a debt is a nonbusiness debt is a question of fact in each particular case. The determination of whether the loss on a debt's becoming worthless has been incurred in a trade or business of the taxpayer shall, for this purpose, be made in substantially the same manner for determining whether a loss has been incurred in a trade or business for purposes of section 165(c)(1). For purposes of subparagraph (2) of this paragraph, the character of the debt is to be determined by the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. If that relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt comes within the exception provided by that subparagraph. * * *

Treas. Reg. § 1.166-5, T.D. 6500, 26 C.F.R. § 1.166-5 (1960)

REG. § 1.166-1(c)

Only a bona fide debt qualifies for purposes of section 166. A bona fide debt is a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money. A gift or contribution to capital shall not be considered a debt for purposes of section 166.

Treas. Reg. § 1.166-1(c), T.D. 6996, 26 C.F.R. § 1.66-1(c) (1970).

STATEMENT OF THE CASE

The taxpayers, M. SETH HORNE and MAURINE D. HORNE, are husband and wife and reside in Phoenix, Arizona. M. SETH HORNE (hereafter referred to as "HORNE") is a real estate developer and investor. In 1951, HORNE and two others formed a general partnership (hereafter the "Partnership") to engage in the business of real estate development. Later that year, the Partnership purchased all the outstanding shares of James Stewart and Co., Inc. (hereafter referred to as "COINC"), thinking that COINC's construction activities would compliment the Partnership's real estate activities. The total purchase price amounted to $296,406.25. COINC's stock was acquired in the names of the individual partners according to their interests in the Partnership. HORNE's basis in the COINC stock was $194,442.50. At that time, COINC had a wholly owned subsidiary, James Stewart Corporation

(hereafter referred to as "CORP"). In 1952, COINC caused a second subsidiary, James Stewart Company (hereafter referred to as "CO") to be formed. Like COINC, both CO and CORP performed construction and general contracting work.

In the conduct of their construction business, the three corporations were required to post performance bonds on the jobs they undertook. Bonds were obtained from the New Amsterdam Casualty Company (hereafter referred to as "NEW AMSTERDAM"). COINC and CORP agreed to indemnify NEW AMSTERDAM for any losses incurred as surety for CO. CORP and CO agreed to in demnify NEW AMSTERDAM from any losses incurred surety for COINC.

From the start, HORNE and the other partners were active in the management of COINC as members of its board of directors. HORNE was immediately made Vice-President. He held that office until 1955, when he was elevated to President and Chairman of the Board -- positions which he held through 1960. HORNE was also a member of the board of directors of both CORP and CO. In 1953, HORNE was elected Vice-President of CORP, and in 1954, chairman of its board. HORNE was president of CO from its inception.

The Partnership was the manager of COINC, and CORP and CO were its operational arms. The Partnership engaged in all phases of real estate development,

although after acquiring COINC, a great deal of the partners' time was devoted to overseeing the parent and its subsidiaries.

During the years 1952 through 1960, HORNE received no compensation of any kind from COINC, CORP or CO for services rendered. Also, none of the corporations paid any dividends during those years. CORP and CO did, however, pay management fees to COINC; and COINC in turn paid management fees to the Partnership.

By 1960, all three corporations were in severe financial trouble. NEW AMSTERDAM was informed that CO could not complete all its contracts and that COINC and CORP did not have sufficient funds to meet their obligations as indemnitors under the cross-indemnity agreements. At this point, NEW AMSTERDAM estimated its liability on the bonds written on CO's behalf at approximately one and one-half million. None of the partners were individually liable on the bonds and therefore NEW AMSTERDAM requested the partners to contract to indemnify it for any loss incurred on the three corporations' bonds. The other partners refused, but HORNE acceded. He did so realizing that unless he agreed, the corporations would be taken over by the bonding company, their assets would be liquidated and they would probably end up in bankruptcy. Not only would he lose his investment in COINC, but, most importantly, his

credit reputation would be ruined. Thus, because the ability to borrow large amounts of money was crucial to the conduct of a real estate development business, HORNE would no longer be able to participate in such business on an individual basis, or as a major figure in a partnership or corporation.

In January 1961, following negotiations, HORNE and NEW AMSTERDAM entered into an indemnity agreement whereby HORNE and CO jointly and severally agreed to pay NEW AMSTERDAM amounts expended by NEW AMSTERDAM pursuant to bonds issued in connection with the contracts previously entered into by CO, and all amounts for which CO was obligated under the earlier cross-indemnity agreements. The agreement between NEW AMSTERDAM and HORNE was unlike usual indemnity agreements entered into by a bonding company and a third-party indemnitor. Generally, a bonding company requires the indemnity agreement at the outset of the transaction and the indemnification is given at the time the bond application is executed. The agreement between NEW AMSTERDAM and HORNE was an original undertaking by him.

Contemporaneous with the negotiation of the January 20 agreement, the Partnership was dissolved and the corporations reorganized with HORNE receiving all the stock in CO.

In accordance with the January 20 agreement, HORNE paid to NEW AMSTERDAM $237,434.46 in 1966, $121.749.22 in 1967, and $238,246.66 in 1968.

He deducted one-half of these amounts as losses. The balance for each year was treated as a loan to CO by HORNE and as an account payable by CO to HORNE.

On February 6, 1970, the Commissioner forwarded to the taxpayers, as required by law, a statutory notice of deficiency by which he disallowed the deductions claimed by HORNE for 1966, 1967, and 1968 on the grounds that the amounts paid by him to NEW AMSTERDAM represented contributions to capital and not losses incurred in a transaction entered into for profit. Alternatively, the Commissioner invoked the provisions of Section 166 of the Internal Revenue Code of 1954, holding that if the amounts paid by HORNE were found to be loans (a) the loans did not become worthless in the taxable year in which the deductions were claimed, or (b) if worthless, the loans were nonbusiness bad debts and therefore subject to the limitations of Section 1211 of the Internal Revenue Code of 1954.

Within the time provided by Section 6213 of the Internal Revenue Code of 1954 (26 USC § 6213), the taxpayers filed a petition with the Tax Court on May 7, 1970, seeking a redetermination of the deficiencies determined to be due from them by the Commissioner. Jurisdiction was conferred on the Tax Court by Sections 6213(a) and 7442 of the Internal Revenue Code. (26 USC §§ 6213(a), 7442).

The Tax Court held that upon payment to the bonding company HORNE was both an indemnitor and a guarantor, that he did acquire a "remedy over" against CO, and this "remedy over" represented a debt falling within the provisions of Section 166. The Tax Court further held that CO was financially able to pay HORNE during the relevant years and the debts were not worthless, and therefore no deduction was allowed. Section 1211 of the Interal Revenue Code of 1954. (26 USC § 1211).

On February 12, 1973, the Tax Court entered its decision pursuant to the opinion filed November 27, 1972. Within the 90-day period set forth in 28 USC § 7483, on May 11, 1973, the taxpayers filed their Notice of Appeal to the United States Court of Appeals for the Ninth Circuit. Jurisdiction was conferred upon that Court by 28 USC § 2483.

On appeal, the Ninth Circuit affirmed. It held that Section 166 is applicable to payments by an indemnitor regardless of the existence of an independent debt between the corporation and the taxpayer. In view of the Tax Court's determination that the debts were not worthless, no deduction was permitted. On October 25, 1975, appellants filed a petition for rehearing. The court denied the petition for rehearing on March 27, 1978.

REASONS FOR GRANTING THE WRIT

I. The decision of the Ninth Circuit is in conflict with Howell v. Commissioner, 69 F.2d 447 (8th Cir., 1934), cert. denied 292 U.S. 654, on the question of whether payments

under an indemnity agreement are to be given bad-debt treatment; in conflict with Stahl v. United States, 441 F.2d 999 (D.C. Cir., 1970) on the question of the applicability of section 166(d) to the instant transaction; and in conflict with Lutz v. Commissioner, 282 F.2d 614 (5th Cir., 1960), on the question of the applicability of section 162 to the inst ant transaction.

A. Howell v. Commissioner, supra, has long been recognized as the controlling case establishing deductible losses under section 165(c). The distinction between a guarantor on the one hand as opposed to the indemnitor on the other, was stated by the court as follows:

> "Although the ordinary surety or guarantor is a creditor of the principal debtor, the same cannot be true of an indemnitor who does not undertake to assume or discharge the obligations of another, but has, on his own account, contracted to pay a sum of money upon the occurrence of a certain event, usually the happening or the ascertainment of a loss. There is no privity, either actual or implied, between the promisor in the undertaking the loss from the nonperformance of which is indemnified against and the indemnitor, and the latter, if the loss occurs, does not, by payment of it, discharge any one's obligations but his own."

69 F.2d at 451.

The error of the Tax Court, which the Ninth Circuit compounded, was their refusal to recognize the January 20 agreement as a new and independent undertaking by HORNE to NEW AMSTERDAM for which he had no personal obligation prior to the agreement. They did so while at the same time recognizing HORNE's motivation for entering into the agreement to be for the purpose of protecting of his financial integrity and reputation as a real estate developer.

Both the Ninth Circuit and the Tax Court likened HORNE's situation to that of the taxpayer in United States v. Hoffman, 423 F.2d 1217 (9th Cir., 1970). However, the Hoffman case presented a question of "substance over form" and the Ninth Circuit concluded from the facts, that Hoffman was a guarantor even though the bonding agreement referred to him as an indemnitor. The facts of that case reflected that the taxpayer-stockholder agreed to indemnify simultaneously with the execution of the bonding application by the corporation with the surety.

Following the Hoffman case, this court decided United States v. Generes, 405 U.S. 93 (1972), which has striking factual similarities to the Hoffman case. In deciding Generes this court did not disapprove of indemnity losses, or the principal of Howell v. Commissioner, supra, but instead resolved a conflict among the circuits as to the motivation tests to be applied in determining whether a debt is deductible as a business bad debt under section 166.

HORNE's transaction with NEW AMSTERDAM was an independent undertaking by him rather than a simultaneous transaction as was apparent in Hoffman, supra. As such HORNE's case falls within the principal of Howell v. Commissioner, supra, which HORNE maintains creates a conflict which must be resolved by this court.

B. Also following the Hoffman decision, the Court of Appeals for the District of Columbia decided Stahl v. United States, supra, which criticized Hoffman and those cases which made a blanket declaration that the principals of Putnam v. Commissioner, 352 U.S. 82 (1956) applied in all cases where a taxpayer-stockholder made an undertaking (whether or not involving subrogation) in order to protect or enhance his position in the corporation. See also, Stratmore v. United States, 420 F.2d 461 (3d Cir., 1970), cert. denied 398 U.S. 951 (1970).

The Stahl case presents a well-reasoned opinion. While the facts differ from those now before the court, it clearly recites the proposition that section 116 has application only to a bona fide debt existing at the time the transaction was entered into. The court, applying the principal of substance over form, Commissioner v. Conat Holding Co., 324 U.S. 331, 334 (1945), held that a loan of securities by the taxpayer to her brokerage firm which she agreed could be used as part of the capital of the firm, did not create a "loan" or an "indebtedness" within the meaning of section 166. Upon the

ultimate loss of the securities, the court held that section 166 had no application because when the transaction was entered into initially there was no bona fide debt as provided by Treasury Regulations § 1.166-1(c), 26 C.F.R. § 1.166-1(c) (1970), to wit:

> "Only a bona fide debt qualifies for purposes of Section 166. A bona fide debt is a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money. A gift or contribution to capital shall not be considered a debt for purposes of Section 166."

441 F.2d at 1003.

Prior to the January 20 agreement there was no debt existing between HORNE and NEW AMSTERDAM. Moreover, the January 20th agreement did not create a debt but merely a promise by HORNE to hold NEW AMSTERDAM harmless from loss. Until that loss arose there was nothing to which section 166 could possibly have had application.

The loss which ultimately came upon HORNE did not follow from a bona fide debt. Treas. Reg. § 1.166-1 (c). Neither did a bona debt come about by the process of subrogation as set forth in Putnam v. Commissioner, supra. HORNE's loss was real and sustained by him for a valid business purpose.

Since there was no bona fide debt to which HORNE's loss could attach, he maintains that section 166

has no application and that his loss was properly deductible pursuant to section 165(c)(1) or (2). HORNE further maintains that Hoffman, supra, is in conflict with Stahl v. Commissioner, supra, and that this conflict constitutes an additional reason for the granting of the writ.

C. The reasoning of Stahl v. Commissioner likewise creates a conflict between the Hoffman case, on the one hand, and Lutz v. Commissioner, supra, on the other. See also Allen v. Commissioner, 283 F.2d 785 (C.A. 7, 1960). Lutz presented facts of the taxpayer-stockholder paying the debts of a corporation to preserve his credit reputation and standing. The Fifth Circuit allowed such payments as deductions under section 162.

HORNE was primarily and dominantly motivated to enter into the January 20th agreement in order to protect his financial integrity and reputation so that he could remain in real estate development. That motivation (see United States v. Generes, supra) carried over to the time when the payments were made by him under the January 20th agreement. The payments were not made to satisfy his "neighborly amenities, or to heighten his reputation for generosity and opulence." Lutz v. Commissioner. They were made by him for a dominantly motivated business purpose. Therefore the payments are also deductible pursuant to section 162.

The holding of the Ninth Circuit to the contrary in Hoffman puts it

in conflict with the Fifth Circuit which conflict should be resolved by this court.

II. The Ninth Circuit's opinion in United States v. Hoffman has created confusion and uncertainty in an important area of federal income tax law which should be settled by this court.

The opinion of the court in United States v. Hoffman was per curiam and as such the opinion does not set forth the Ninth Circuit's reason in detailed analysis with respect to its approach to an important issue of federal income tax law of first instance. Before Hoffman the question of an "indemnitor" being the same as a "guarantor" had not been decided.

In HORNE's case, the Ninth Circuit had an opportunity to speak with clarity on the issue; however, it is respectfully submitted that the court's reasoning is fundamentally wrong as a matter of law. In the Ninth Circuit's opinion it was stated that HORNE sought to distinguish Putnam v. Commissioner, supra, and United States v. Hoffman, on the grounds that the essence of the Putnam rule was that the taxpayer as guarantor acquired upon payment a claim against the corporation by subrogation, which was the ultimate "debt" that became worthless. It was further pointed out that:

> "the loss resulting from [the worthlessness of a nonbusiness debt] . . ..includes not only any loss sustained by the obligee of

> the debt but any loss sustained by a third party. [The court concluded that] the section is triggered by the worthlessness of the principal debt, and no independent debt between principal debtor and the third party, created by subrogation, is necessary." [sic]

HORNE submits the court's analysis to be fundamentally wrong. The Ninth Circuit has referred to section 166 (d)(1) as a source definition of the character of HORNE's loss. However, HORNE submits that those provisions relate to the treatment to be accorded the loss, not its definition. Section 166(d)(2) defines the nature of the nonbusiness bad debt to be a debt created or acquired in connection with a trade or business of the taxpayer; or a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business. Treasury Regulation § 1.165-5 refines further, by providing:

> " * * *
> (b) Nonbusiness debt defined--For purposes of section 166 and this section, a nonbusiness debt is any debt other than--
>
> "(1) A debt which is created, or acquired, in the course of a trade or business of the taxpayer, determined without regard to the relationship of the debt to a trade or business of the taxpayer at the time when the debt becomes worthless; or
>
> "(2) A debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

"The question whether a debt is a nonbusiness debt is a question of fact in each particular case. The determination of whether the loss on a debt's becoming worthless has been incurred in a trade or business of the taxpayer shall, for this purpose, be made in substantially the same manner for determining whether a loss has been incurred in a trade or business for purposes of section 165(c)(1). For purposes of subparagraph (2) of this paragraph, the character of the debt is to be determined by the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. If th at relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt comes within the exception provided by that subparagraph. * * * (Emphasis supplied)

Treas. Reg. § 1.166-5, T.D. 6500, 26 C.F.R. § 1.166-5 (1960)

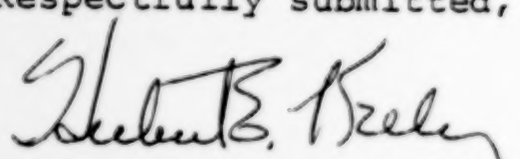
HORNE maintains that the record is uncontradicted in its support that prior to the January 20th agreement COINC, CORP and CO were in irreversible financial difficulty and for all practical purposes bankrupt. The "debt" to which the Ninth Circuit has referred was at that time worthless. Had HORNE acquired the debt at that time section 166 would not have applied as it is well established that section 166 does not apply where the debt was worthless when acquired. Eckert v. Burnet, 283 U.S. 140 (1931).

The foregoing constitutes additional reason why HORNE's loss does not fall within the debt provisions of section 166. More importantly, however, the Ninth Circuit has not spoken in Hoffman, supra, with clarity on the one hand while at the same emasculating the losses of true indemnitors under section 165(c). That coupled with the additional questions and conflicts raised by Stahl v. Commissioner, supra, and Lutz v. Commissioner, supra, taken together with the possibility of conflict with United States v. Generes, supra, creates an atmosphere of uncertainty and confusion in the area of federal income tax law which should be resolved by this court.

CONCLUSION

For the foregoing reasons, it is respectfully prayed that this court grant this petition for a writ of certiorari to the United States Court of Appeals for the Ninth Circuit herein.

Respectfully submitted,



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June 23, 1978

CERTIFICATION OF SERVICE

I, HUBERT E. KELLY, attorney for Appellants, hereby certify that I served by mail four (4) true and correct copies of the PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT on counsel for Appellee, Commissioner of Internal Revenue, on the 23rd day of June, 1978, by placing said copies in an envelope addressed to M. Scott Ferguson, Assistant Attorney General, Tax Division, United States Department of Justice, Washington, D.C. 20530; said envelope was then sealed and deposited in the United States Post Office at Phoenix, Arizona, on the aforesaid day with the postage thereon fully paid.

Hubert E. Kelly
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